

TITLE 18. FRANCHISE TAX BOARD

As required by section 11346.4 of the Government Code, this is notice that a public hearing has been scheduled to be held at 10:00 a.m., August 17, 2007, at 9646 Butterfield Way, Town Center Golden State Room A/B, Sacramento, California, to consider adoption of an amendment to existing Regulation section 25137(c) under Title 18 of the California Code of Regulations. This proposed regulatory action is specifically authorized under section 25137 of the California Revenue and Taxation Code, pertaining to the use of alternative apportionment methodologies.

An employee of the Franchise Tax Board will conduct the hearing. Thereafter, a report will be made to the three-member Franchise Tax Board for its consideration. Government Code section 15702, subdivision (b), provides for consideration by the three-member Board of any proposed regulatory action if any person makes such a request in writing. The three-member Board will consider the proposed regulation and comments submitted with respect to the proposed regulation prior to acting upon it at one of its meetings.

Interested persons are invited to present comments, written or oral, concerning the proposed regulatory action. It is requested, but not required, that persons who make oral comments at the hearing also submit a written copy of their comments at the hearing.

WRITTEN COMMENT PERIOD

Written comments will be accepted until 5:00 p.m., August 17, 2007. All relevant matters presented will be considered before the proposed regulatory action is taken. Comments should be submitted to the agency officer named below.

AUTHORITY & REFERENCE

Section 19503 of the Revenue and Taxation Code authorizes the Franchise Tax Board to prescribe regulations necessary for the enforcement of Part 10 (commencing with section 17001), Part 10.2 (commencing with section 18401), Part 10.7 (commencing with section 21001) and Part 11 (commencing with section 23001) of the Revenue and Taxation Code. Section 25137 of the Revenue and Taxation Code provides the Franchise Tax Board with the authority to require, in cases where the standard apportionment formula does not fairly represent the extent of the taxpayer's business activity in this state, alternative methods to effectuate an equitable and effective allocation and apportionment of a taxpayer's income. The proposed regulatory action interprets, implements, and makes specific section 25137 of the Revenue and Taxation Code.

INFORMATIVE DIGEST/PLAIN ENGLISH OVERVIEW

Taxpayers who have business activities within and without California are required to determine the amount of income properly attributed to activities in California by use of the Uniform Division of Income for Tax Purposes Act (UDITPA), Section 25120 et seq., Revenue and Taxation Code (RTC). Under UDITPA, business income is assigned to a state through the application of a three-factor apportionment formula that separately compares a business' property, payroll and sales within California to those values everywhere. These three percentages are then added together and divided by three. For most California taxpayers the sales factor is counted twice (see RTC section 25128), and the resulting sum of these four factors is then divided by four. This percentage is then applied to the business income of the taxpayer to determine the percentage of business income attributable to California.

The three-factor apportionment formula was adopted as a way of reflecting the different elements that provide value to a taxpayer's operation in a given state. The payroll factor reflects the amount of labor utilized by the taxpayer in performing its activities in the state. The property factor reflects the amount of capital utilized by the taxpayer in the state. The sales factor reflects the market for the goods or services of the taxpayer in the state. It has been stated that the purpose of the sales factor is "to give weight to the obtaining of markets", balancing to some extent property and payroll factors that favor production or manufacturing states.

The proposed amendment to Regulation section 25137(c) addresses the treatment of receipts derived from a taxpayer's "treasury function" activity. A treasury function involves the pooling, management, and investment of intangible assets for the purpose of satisfying the cash flow needs of the trade or business, such as providing liquidity for a taxpayer's business cycle. The treatment of treasury function activities in the sales factor has given rise to disputes as far back as the Board of Equalization's decision in Appeal of Pacific Telephone and Telegraph Co. (1978) 78-SBE-028 where the Board of Equalization held that the inclusion of treasury function receipts in the sales factor was distortive and that this distortion could be remedied by the Franchise Tax Board through the use of an alternative apportionment formula.

More recently, the California Supreme Court approved of the use of an alternative formula for treasury function activities. In Microsoft Corporation v. Franchise Tax Board (2006) 39 Cal.4th 750, the Court held that the inclusion of Microsoft's treasury function receipts in the sales factor denominator was distortive and upheld the Franchise Tax Board's use of an alternative formula which removed the receipts and included only net income from the treasury function in the sales factor denominator. In its opinion, the Court noted the Court of Appeals' policy argument that a systematic exclusion of these receipts may be preferable. The Court also cited to numerous examples where states have amended UDITPA to achieve this result, including the Multistate Tax Commission's model regulation regarding the treasury function, but concluded that the Court was not free to judicially amend UDITPA.

In a second case, General Motors Corporation v. Franchise Tax Board (2006) 39 Cal 4th 773, also involving this same issue, the California Supreme Court considered the nature of the particular investments, in that case repurchase agreements, and held that the proceeds from loans would be subject to different treatment for sales factor purposes. As a consequence, additional litigation can be expected as to the nature of various other financial instruments invested in as part of a treasury function, thus fostering continuing uncertainty in this area as to what should be included and what should be excluded from the sales factor.

This regulation is a response to the existing case law and functions to remove the gross receipts from a "treasury function" from the sales factor to eliminate future controversies. Taxpayers will retain the right to contest whether the removal of these receipts results in an unfair reflection of their activities in California under Section 25137 of the Revenue and Taxation Code, but will bear the burden of proof to establish that unfair reflection.

DISCLOSURES REGARDING THE PROPOSED REGULATORY ACTION

Mandate on local agencies and school districts: None.

Cost or savings to any state agency: None.

Cost to any local agency or school district which must be reimbursed under Part 7, commencing with Government Code section 17500, of Division 4: None.

Other non-discretionary cost or savings imposed upon local agencies: None.

Cost or savings in federal funding to the state: None.

Significant statewide adverse economic impact directly affecting business including the ability of California businesses to compete with businesses in other states: None.

Potential cost impact on private persons or businesses affected: The Franchise Tax Board is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action. At interested parties meetings held by the Franchise Tax Board staff, comments were made that a failure to regulate would require businesses to address the question of whether the standard formula results in a fair reflection of income on a case-by-case basis every year, and that this would give rise to substantial additional compliance costs for taxpayers. As a result of this comment, the Franchise Tax Board believes that this regulation will reduce this compliance burden by providing further certainty to taxpayers.

Significant effect on the creation or elimination of jobs in the state: At an interested parties meeting, comments were offered that failure to adopt the regulation might cause California-based companies to move their treasury departments out of state, with a resulting loss of jobs within California.

Significant effect on the creation of new businesses or elimination of existing businesses within the state: None.

Significant effect on the expansion of businesses currently doing business within the state: None.

Effect on small business: The allocation and apportionment rules are only utilized by multijurisdictional businesses, most of which are not small businesses. In addition, small businesses are unlikely to have staff performing a treasury function.

Significant effect on housing costs: None.

CONSIDERATION OF ALTERNATIVES

In accordance with Government Code section 11346.5, subdivision (a)(13), the Board must determine that no alternative considered by it would be more effective in carrying out the purpose for which the action is proposed or would be as effective and less burdensome to affected private persons than the proposed regulatory action.

AVAILABILITY OF STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATIONS

An initial statement of reasons has been prepared setting forth the facts upon which the proposed regulatory action is based. The statement includes the specific purpose of the proposed regulatory action and the factual basis for determining that the proposed regulatory action is necessary.

The express terms of the proposed text of the regulation and the initial statement of reasons and the rulemaking file are prepared and available upon request from the agency contact person named in this notice. When the final statement of reasons is available, it can be obtained by contacting the agency officer named below, or by accessing the Franchise Tax Board's website mentioned below.

CHANGE OR MODIFICATION OF ACTIONS

The proposed regulatory action may be adopted by the Franchise Tax Board after consideration of any comments received during the comment period.

The regulation may also be adopted with modifications if the changes are nonsubstantive or the resulting regulation is sufficiently related to the text made available to the public so that the public was adequately placed on notice that the regulation as modified could result from that originally proposed. The text of the regulation as modified will be made available to the public at least 15 days prior to the date on which the regulation is adopted. Requests for copies of any modified regulation should be sent to the attention of the agency officer named below.

ADDITIONAL COMMENTS

If you plan on attending or making an oral presentation at the regulation hearing, please contact the agency officer named below.

The hearing room is accessible to persons with physical disabilities. Any person planning to attend the hearing who is in need of a language interpreter or sign language assistance, should contact the officer named below at least two weeks prior to the hearing so that the services of an interpreter may be arranged.

CONTACT

All inquiries concerning this notice or the hearing should be directed to Colleen Berwick at the Franchise Tax Board, Legal Branch, P.O. Box 1720, Rancho Cordova, CA 95741-1720; Telephone (916) 845-3306; Fax (916) 845-3648; E-Mail: colleen.berwick@ftb.ca.gov. The notice, initial statement of reasons and express terms of the regulation are also available at the Franchise Tax Board's website at www.ftb.ca.gov.